

**UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
ENVIRONMENTAL FINANCIAL ADVISORY BOARD**

**Applications of the Cross-Collateralization Language
to Various State Revolving Fund Structures**

December 8, 1997

Mr. Robert Perciasepe
Assistant Administrator for Water (4101)
Environmental Protection Agency
401 M Street S.W.
Washington, D.C. 20460

Dear Mr. Perciasepe:

We are pleased to provide you with a report of the Environmental Financial Advisory Board (EFAB) on "Applications of Cross-Collateralization Language to Various State Revolving Fund Structures." The report presents the informed views of three nationally known bond counsels on how the recent language in the Agency's appropriations bill might apply to several leveraged revolving fund structures. Emphasis is given to the opportunities opened by the bill language.

As we have in previous reports on the cross-collateralization issue, the Board wants to underscore the need for flexibility on EPA's part with respect to implementation. A high degree of flexibility provided the states will ensure that the maximum potential of this important leveraging tool is achieved.

If you wish to discuss this report or if we can be any other assistance, please let us know.

Respectfully submitted,

(signature)

Robert O. Lenna
Chair, EFAB

(signature)

John C. Wise
Executive Director, EFAB

Attachment

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This report has not been reviewed for approval by the U.S. Environmental Protection Agency; and hence, the views and opinions expressed in the report do not necessarily represent those of the Agency or any other agencies in the Federal Government.

ENVIRONMENTAL FINANCIAL ADVISORY BOARD

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Introduction

The Environmental Financial Advisory Board (EFAB) has strongly supported the discretion and flexibility of States to cross-collateralize their Clean Water Revolving Funds with the newly formed Drinking Water Revolving Funds.

During the fiscal year 1998 appropriations process, Congress took several significant actions to make cross-collateralization a reality. First, Senate Report 105-53 on S.1034 contained this clear statement of congressional intent: "the Committee has included bill language allowing States to cross-collateralize their clean water and drinking water State revolving funds. This language *makes explicit that funds appropriated to the SRFs may be used as common security in a bond issue for both SRFs, ensuring maximum opportunity for leveraging these funds.*"(emphasis added)

Subsequently, the Conference Report on the Appropriations Bill added further reinforcement: "Bill language has been included which: *(1) authorizes cross-collateralization of clean water and safe drinking water state revolving funds as security for bond issues.*" (emphasis added, House Report 105-297 on the Conference of H.R. 2158.)

The Bill itself gives cross-collateralization the force of law:

" . . . notwithstanding any other provision of law, States may combine the assets of State Revolving Funds (SRFs) established under section 1452 of the Safe Drinking Water Act, as amended, and title VI of the Federal Water Pollution Control Act, as amended, as security for bond issues to enhance the lending capacity of one or both SRFs, but not to acquire the state match for either program, provided that revenues from the bonds are allocated to the purposes of the Safe Drinking Water Act and the Federal Water Pollution Control Act in the same portion as the funds are used as security for the bonds . . . "

Cross-collateralization permits leveraged SRFs to enhance lending capacity per federal grant and state match dollar by helping to achieve better programmatic ratings. The language permitting cross-collateralization has been interpreted to permit workable cross-collateralization structures within the context of different types of leveraged SRFs.

Following is a discussion by three nationally-recognized bond counsel firms of their interpretation of the cross-collateralization language and its application to the specific programs they advise.

New York SRF Programs

The Water Pollution Control Revolving Fund (the "Clean Water SRF") administered by the New York State Environmental Facilities Corporation ("EFC") in conjunction with the State Department of Environmental Conservation includes what is commonly referred to as a leveraged program with so-called "over-sized" reserves. Under this program, bonds are generally issued under financing indentures and the proceeds of the bonds are loaned to multiple governmental borrowers. The repayment obligations of the borrowers are the principal source of repayment of the bonds and are pledged as security for the bonds. Federal capitalization grants and state matching funds are allocated to each loan as "corpus allocations" and pledged as security for the loans and (indirectly) the bonds issued to investors. Earnings on the corpus allocations subsidize the loan debt service paid by the borrowers. The amount held as corpus allocation for each loan is proportionately reduced over time as the principal amount of the related loan is repaid. The principal of the corpus allocation for any loan is available to cure any default by a borrower on that loan and, assuming it is not needed for that purpose, as the principal amount of any corpus allocation is reduced, the "freed up" amounts are available first to cure any default under any other loan made with the proceeds of bonds issued under the same indenture and second to cure any defaults under any other loan made with proceeds of any bonds issued under the program pursuant to other indentures. The size of the corpus allocation for each loan has been established pursuant to state legislation and has varied between one-third and one-half of the principal amount of the loan, depending on when the loan was made and the characteristics of the loan and the project being financed.

If amounts of corpus allocation which are freed-up are not required to be utilized as described above, they are then available to support any subordinate debt issued as part of the program (currently one subordinate series of bonds issued for the purpose of refunding some prior Clean Water SRF Bonds is outstanding). Thereafter such amounts are available for any purpose to which Clean Water SRF moneys may be applied. Subordinated bonds may be issued for any eligible purpose permitted under the relevant state legislation.

The new Drinking Water Revolving Fund (the "Drinking Water SRF") will be administered by EFC, in conjunction with the State Department of Health. Applicable state legislation generally mirrors the provisions applicable to the Clean Water SRF and contemplates a program that would be financed and implemented in manner generally similar to the Clean Water SRF. Relevant state legislation provides broad authority for transferring moneys between the Clean Water SRF and the Drinking Water SRF and authorizes such moneys transferred from one fund to be used for the other funds purposes and, subject to among other things, certain approvals and accounting requirements, authorizes moneys in the two funds to be held together.

Potential Approaches to Cross Collateralization

A variety of potential mechanisms for possible utilization of cross collateralization have been proposed for use under the New York programs and are under consideration.

One possible approach would be the amendment of the existing master financing indenture

under which most of the program's Clean Water loans have been made to allow Drinking Water SRF bonds to be issued under it on a parity basis. A second possible approach would be to issue Drinking Water SRF bonds which would be entitled to the subordinate lien described above. A third approach would potentially involve the purchase of bonds issued under one program as an "investment" by the other program.

No decisions have been made as to whether, or if, one or more of these approaches or other approaches will be utilized.

Issues Likely to be Faced in Connection with Cross-Collateralization

The recently enacted EPA appropriations bill offers support for the possible cross-collateralization approaches under consideration, although some questions remain.

Most fundamentally, even read broadly, the authorization set forth in the EPA Appropriations bill will not override existing indenture covenants with bondholders if they preclude, for example, issuance of parity bonds under an existing indenture for purposes or to borrowers not contemplated thereby. These types of restrictions may present issues in some states for the issuance of parity debt under existing indentures as a means of implementing cross collateralization. The existing master financing indenture contains reasonably flexible provisions allowing amendments to the extent such amendments are determined not to be materially adverse to the interest of outstanding bondholders. As a consequence, it is expected that amendments would be permissible to allow issuance of parity Drinking Water SRF bonds under the existing master financing indenture for many of the purposes authorized to be financed under the new program if EFC and other involved State agencies determine to pursue this course and it is permitted under applicable federal law. It is similarly expected that subordinated debt could be issued under the existing program for this purpose.

Assuming that State law questions and indenture questions can be favorably resolved, the authorization contained in the appropriations bill does raise certain questions regarding some of the approaches under consideration which will need to be addressed. The most significant of which will be the interpretation of the final proviso which requires that the "revenues from the bonds are allocated to the purposes of the Safe Drinking Water Act and the Federal Water Pollution Control Act in the same portion as the funds used as security for the bonds."

The phrase "revenues from the bonds" almost certainly was intended to include at least the proceeds of bonds which may be secured by "combined" assets. It could be asserted that the term "revenues" might be read broadly to also encompass the payments received on loans made with the proceeds of such bonds. However this seems unlikely to have been the intent of Congress in light of the use of the phrase "revenues from the bonds" which presumably was intended to be read more narrowly than the reference to the "assets" of the funds generally used in the same sentence. Assets of the funds presumably would be read to include loans and repayments thereof, as well as revenues from bonds issued under the programs. Giving the term revenues its more natural and narrow construction is supported by the fact that requiring that all loan repayments be allocated proportionately could be a nightmare for agencies from an operational and accounting perspective and would significantly undermine the benefits Congress sought to achieve by authorizing cross collateralization.

The requirement that revenues be allocated "in the same portion as the funds are used as security for the bonds..." also presents issues which will need to be considered. Since different loans under the existing program received different percentage levels of corpus allocation and the corpus allocations which will be made in the future under the Clean Water program and the Drinking Water program will probably vary over time, a requirement of strict proportionality may be operationally difficult or impossible to adhere to. Nothing in the recently enacted appropriations bill or its legislative history suggests that Congress intended to force states to shut down existing Clean Water SRF programs and begin anew. Indeed, the most apparent purpose of the authorizing language would seem to be to allow the strength of the existing programs to be used to enhance the new programs. This being the case, it seems reasonable, at a minimum, to interpret the requirement of proportionality so as to allow deviations from strict proportionality of asset pledges to the extent such deviations are consistent with existing programs, financing document requirements and law in effect at the time the legislation was enacted. In addition, on a going forward basis some parameters or guidelines might be developed that would recognize and permit temporary deviations from proportionality to occur so long as mechanisms were in place that assured that substantial proportionality would be achieved or restored over time.

Conclusion

As the discussion above and in the following sections suggest, the issues raised by the possibility of cross-collateralization between Clean Water SRF and Drinking Water SRF programs are very complex. In addition to questions of federal law and regulation, the issues reflect questions of state law and interpretations of indentures which will necessarily vary state to state and may vary indenture to indenture, within a single state's program.

Since the permissible approaches to cross-collateralization will necessarily vary, the fairest and best interpretation of the recently enacted federal authorization of cross collateralization may be developed in the context of a consideration by EPA of the particular programs which may be advanced by the states. A prescriptive or detailed interpretation made at this time - without the benefit of detailed consideration of a particular proposed applications of the recently enacted authorization - may inadvertently preclude the development of particular programs which, if considered in light of their own circumstances, would be found to be consistent with applicable law.

Rather, it is suggested that broad guidance should be given at this time to allow cross-collateralization to be implemented by the states in a manner consistent with the recently enacted legislation, with the consistency of each particular program to be determined on a case by case basis in accordance with EPA normal review of grant applications.

Prepared by: B. Van Dusen; Hawkins, Delafield & Wood

Massachusetts Water Pollution Abatement Trust

The Massachusetts Water Pollution Abatement Trust operates a "leveraged" state revolving

fund program under Title VI of the Clean Water Act which is similar to leveraging programs implemented in a number of states. Currently the Trust has over \$800 million in loans outstanding under six financing indentures (including four indentures which permit parity additional bonds) and a master program indenture.

Bonds issued under each financing indenture are secured by the loans funded by the issue and by repayments on the loans, substantial state subsidy appropriations and investment income. The bonds are additionally secured by a debt service reserve fund which is funded by federal capitalization grants and associated state matching grants in an amount equal to 50% of the principal amount of the bonds and loans outstanding under the applicable financing indenture (thus resulting in a 2 to 1 leveraging ratio of loan principal amount to the amount of capitalization grants contributed to each issue). As loans and bonds are repaid, amounts are released from the debt service reserve funds under the financing indentures and are transferred first to a "deficiency reserve fund" maintained under the master program indenture and second to the Trust's "equity" fund for application to additional loans. While held in the deficiency reserve fund, amounts attributable to federal capitalization grants and state matching grants which have been released from one financing indenture may be applied to cure loan defaults under any other financing indenture if all amounts available in the debt service reserve fund under that indenture have been exhausted.

The Trust expects to implement a leveraged revolving fund program under the Safe Drinking Water Act early in 1998 utilizing a bond structure similar to its Clean Water Act program. In view of the limited initial capitalization of the Safe Drinking Water Act program and the varied credit profile of safe drinking water program borrowers, the Trust also may seek to "cross-collateralize" bonds issued for both of its programs with a common debt service reserve funded by both Clean Water Act capitalization grants and Safe Drinking Water Act capitalization grants and/or with the common "deficiency" reserve fund under the master program indenture.

H.R. 2158 provides sufficient authorization for cross-collateralization in the context of the Trust's leveraged bond program as currently contemplated. Consistent with the requirements set forth in H.R. 2158, our opinion assumes that (1) the capitalization of the combined program will be independent of cross-collateralization (i.e., the amount of federal capitalization grants contributed to each program will be independently calculated for all regulatory purposes (e.g., calculation of binding commitments, "first-use" requirement, "cash draw", etc.); in addition, the state match contributed to one program will not be used to meet the state match requirement for the other program), and (2) the proceeds of the bonds will be allocated to the two programs in direct proportion to the amount of federal capitalization grants and associated state matching grants pledged as security for the bonds (e.g., if \$4 of Clean Water Act capitalization grants and \$1 of Safe Drinking Water Act capitalization grants are contributed to the debt service reserve fund under a financing indenture, then 4/5 of the bond proceeds must be used to fund loans for Clean Water Act projects and 1/5 of the bond proceeds must be used to fund Safe Drinking Water Act projects).

It is also likely that the Trust has retained sufficient flexibility in those provisions of its financing indentures and its master program indenture which pertain to the amendment of the

indentures and the issuance of additional indebtedness to permit the issuance of bonds to fund Safe Drinking Water Act projects on a parity with outstanding bonds issued to fund Clean Water Act projects. We would expect that the same rules of proportionality would apply in such cases.

The foregoing opinions further assume that EPA's implementing regulations or guidance will not contain an overly restrictive interpretation of the last clause contained in the relevant provisions of H.R. 2158 authorizing cross collateralization (i.e., "provided that revenues from the bonds are allocated to the purposes of the Safe Drinking Water Act and the Federal Water Pollution Control Act in the same portion as the funds are used as security for the bonds"). As indicated in the foregoing paragraph, in the context of a leveraged program similar to that instituted in Massachusetts, for purposes of calculating the proportional allocation required by H.R. 2158, we interpret the phrase "revenues from the bonds" to refer only to original bond proceeds which are applied to fund loans, and the use of funds "as security for the bonds" to refer only to the initial funding of the debt service reserve fund with funds allocable to capitalization grants and associated state matching grants. We do not consider the referenced clause to refer to loan repayment proceeds or funds allocable to capitalization grants and state matching grants which are released from the debt service reserve funds upon loan repayment and which would be available to meet defaults on any other loans (and bonds) funded under that indenture or any other regardless of the federal program to which such loans (or bonds) are allocable.

Given the proportional capitalization of the Trust's Clean Water Act and Safe Drinking Water Act programs as described above, absent loan default, loan repayments will result in an equally proportional replenishment of the Clean Water Act and Safe Drinking Water Act revolving funds. In the event of a loan default allocable to one federal program, all capitalization grants allocable to that program which are pledged to the particular series of bonds would be utilized to avoid a bond default before any capitalization grants allocable to the other federal program are so utilized. Default recoveries also could be used to replenish any draws on the other program first. In view of the security structure for the Trust's loans, the diversification of its loan portfolio and the substantial state subsidies available to the Massachusetts program which are also used to secure the Trust's bonds, the likelihood of permanent diminution of either revolving fund due to loan defaults is considerably remote.

Prepared by: Robert H. Hale; Palmer and Dodge L.L.P.

The Ohio SRF: Cross-Collateralization in a Cash-Flow Model Program

The provision in HR 2158 (the recent EPA appropriations bill) for cross-collateralization of existing Clean Water SRFs (CWSRFs) and new Drinking Water SRFs (DWSRFs) may prove to be a useful tool for states striving to maximize the creditworthiness and leveraging capacity of both programs. The challenge for the states will be to achieve that goal as fully as possible within the restrictions imposed by trust agreements securing outstanding CWSRF bonds and by the proportional allocation requirement in the proviso at the end of the cross-collateralization provision.

The CWSRF operated by the Ohio Water Development Authority (OWDA) and the Ohio Environmental Protection Agency (OEPA) provides an example of a "cash-flow model" for an SRF. Under this model, the SRF utilizes its federal capitalization grants and moneys from other sources (e.g., appropriated state funds and proceeds of state match bonds or leveraging bonds) to make loans to local governments and other eligible borrowers. The loan payments, or portions of them, are then pledged as security and used as the source of payment for bonds, and the proceeds of those bonds are in turn used to make more loans, and the self-replenishing SRF continues the cycle. To make the bonds it issues more creditworthy (and thereby achieve more advantageous borrowing terms), the SRF typically structures its bond issues so that less than all of the scheduled loan repayments are needed for debt service (i.e., principal and interest payments) on the bonds. Under such a "coverage" provision, the SRF might promise bondholders that the expected loan repayments will cover the scheduled debt service at least 1.05 times. Assuming no defaults by borrowers in their loan payments, at least five percent of those payments then becomes "surplus" that is available for purposes of the SRF other than debt service.

The trust agreements that secure bonds issued under the cash-flow model typically prohibit the state from pledging or using the pledged loan payments to secure or pay any debt obligations other than "parity" debt issued for the purposes of the SRF. The trust agreements may afford the state greater flexibility in using surplus money derived from loan repayments, perhaps limiting its use only to any lawful purpose.

The first challenge confronting a state (and its bond counsel) seeking to utilize the cross-collateralization provision will be to determine whether trust agreements securing bonds that the state has already issued for its CWSRF will permit the use of any assets of the CWSRF to secure bonds that the state may issue for the new DWSRF. This analysis will raise two main questions:

May the state issue bonds for the DWSRF on a parity with outstanding CWSRF Bonds and secured them by a parity lien on payments of loans made under the CWSRF?

May the state legally use surplus money derived from CWSRF loan payments to make payments on DWSRF bonds that otherwise have no pledge of or lien on CWSRF loan payments?

Trust indentures securing outstanding bonds for cash-flow-model CWSRFs typically allow parity bonds to be issued only for the purpose of providing additional funds for the CWSRF. State laws under which the CWSRF Bonds are issued may have a similar restriction. Congress might nullify such restrictions with legislation declaring DWSRFs to be part of, and inseparable from, CWSRFs, so that the purposes of the latter would also be those of the former. Were Congress to do so, then bonds issued for a DWSRF would also be deemed to be bonds issued for its kindred CWSRF, and the barrier to parity issues would fall. Congress apparently did not intend to do that in enacting the new cross-collateralization provision: that provision permits the combining of assets for limited purposes, but it does not meld the new DWSRFs into the existing CWSRFs. That being the case, existing trust agreements of the sort described above will continue to create serious legal questions as to whether bonds

issued for DWSRFs may be secured on a parity with bonds issued for CWSRFs.

The existing trust agreements may, however, allow greater flexibility for the uses of surplus moneys in the CWSRF than they do for the proceeds of bonds issued for the CWSRF or for the loan repayments that are dedicated to pay debt service on those bonds. They may, for example, permit the surplus moneys to be used for any lawful purpose of the CWSRF. The new cross-collateralization provision may be useful in expanding the permitted uses of surplus moneys for the benefit of new DWSRFs by making the pledge of the surplus moneys to secure DWSRF bonds a legal use of CWSRF money.

States that operate cash-flow-model CWSRFs may also have the ability to avoid impediments to cross-collateralization that their existing trust agreements may create by closing down those trust agreements and issuing new CWSRF and DWSRF bonds under a new trust agreement that clearly permits the sharing of the security for both categories of bonds. This approach will require a state and its counsel to reach two conclusions: first, that state law will permit the issuance of such bonds with a common security pool; and second, that the existing CWSRF trust agreements will permit the transfer of some assets (e.g., loans or surplus loan repayments) to the new program if such a transfer is desired to "seed" the new program.

If a state determines to use surplus money from its existing CWSRF to provide security for new DWSRF bonds, and if the state concludes that it can do so under its existing CWSRF trust agreements to the extent that the new cross-collateralization provision makes that use legal, the state and its counsel must then conclude that the use is consistent with the cross-collateralization provision. To do so, the state must make sure that "revenues from the bonds are allocated to the purposes of the Safe Drinking Water Act and the Federal Water Pollution Control Act in the same portion as the funds are used as security for the bonds."

To make the cross-collateralization provision workable in this situation, there first must be an understanding of what constitutes "revenues" and "use." The provision will be unworkable unless the state and its counsel can readily determine, at the point in time when the new DWSRF bonds are being issued, that the requirements are being met. To that end, "revenues from the bonds" should be interpreted as the immediate proceeds from the sale of the bonds. If a more expansive interpretation were imposed (e.g., one that included in "revenues" all the future revenues that the bonds' proceeds might be deemed to generate), then the amount of "revenues from the bonds" becomes practically indeterminable, and the cross-collateralization provision becomes useless. Similarly, for the cross-collateralization provision to be useful, the proviso's phrase "used as security" must relate to the extent to which the pledged surplus moneys are pledged, not the extent to which they might actually and ultimately be used for payment, which will usually be expected to be zero and which in any event will be indeterminable at the time of the issue.

Assuming that "revenues" and "use" are interpreted as suggested above, how may a state make the allocation of the proceeds of bonds in compliance with the proviso? Several possibilities suggest themselves. The State might make the entire amount of surplus money that may be on hand at any time in the CWSRF available to holders of both CWSRF bonds and DWSRF bonds to whatever extent those moneys may be needed to prevent or cure payment defaults to either class of bondholders. Since both categories of bonds would have

an equal claim on the surplus moneys if needed, the proportional allocation requirement arguably would require the proceeds of the new bonds to be allocated equally between the CWSRF and the DWSRF. But another view, based on the respective principal amount the two categories of bonds, may call for a different result. If the respective claims of holders of the two categories of bonds on the surplus moneys are deemed to be proportional to their principal amounts or their annual debt service requirements, then far more than half of the proceeds of the new bonds would have to be allocated to the CWSRF to meet the proviso's requirements, since far more CWSRF bonds will be outstanding under an existing program. The obvious problem with that solution is that it defeats the purpose for which the state desires to use cross-collateralization: to enhance the lending capacity of the new DWSRF.

One other possibility should enable a state to make use of the cross-collateralization provision without significantly curtailing the extent to which it can allocate proceeds of cross-collateralized bonds to the new DWSRF. The state may choose to dedicate some or all of the existing CWSRF surplus money exclusively for the benefit of the holders of the new DWSRF bonds. If those moneys may be used solely for the purpose of the DWSRF, then their pledge for that purpose should not result in a required allocation of any of the new bonds' proceeds to the CWSRF. The potential difficulty this approach may encounter is that it may result in an unacceptable diminution of the perceived security for the outstanding and future CWSRF bonds.

The cross-collateralization provision in HR 2158 creates new but complex opportunities for the structuring of SRF financings. The administrators of SRFs and their legal counsel and financial advisors will need to work with EPA to utilize the cross-collateralization provision in ways that achieve the maximum benefit the new law allows.

Prepared by: David S. Goodman, Esq.; Squire, Sanders & Dempsey L.L.P.

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The structures described above make it clear that cross-collateralization is only a stand-by security feature that neatly addresses rating agency criteria on pooled financings. The cross-collateralization mechanisms described are unlikely to ever result in the transfer of funds from one SRF to another. More importantly, given the collection performance and vast assets held under each SRF, cross-collateralization will not result in the permanent transfer of corpus from one SRF to the other.

The legal basis for cross-collateralization now firmly exists. EFAB would like to offer its services in assisting the agency with implementation of this important leveraging tool. While formal guidance may not be necessary, to the extent any additional information would prove useful to EPA and the SRFs, EFAB would gladly participate in its development.

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